

Making *Takāful* System Really Worthwhile

“And help one another in righteousness and piety and do not help one another in evil deeds and enmity” (Qur’ān; 5:2)

“The attitude of the believer and feeling of brotherhood to one another is like that of the single body. When one part of the body is hurt, it shall have an effect on the whole body.”
(*ḥadīth; Muttafaq ‘al-ḥy*)

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JEL Classification: G22

Takāful as an alternative to the insurance system is working in various parts of the world for last three and half decades. According to the latest EY report, ‘it expanded at a compound annual growth rate of 22 per cent between 2007 and 2011, although the growth decelerated to a more sustainable 16 per cent in 2012’. However, the growth has been driven largely by a handful of countries, with four countries accounting for 90 per cent of the total global market. In some countries with majority Muslim population like Pakistan, Nigeria, Egypt and Bangladesh, the *takāful* market can be considered very much in the developing stage. While Muslims account for almost a quarter of the global population, Shari’ah compliant assets still make up only about 1 per cent of the world's total. (Souhail Jaffer; cf: IFN, Feb. 2014)

The emergence of *takāful* can be traced back to the pre-Islām historical systems of *al-nahd* (partnership in the provisions on mutual basis), *al-‘āqilah* (kinsmen paying blood money to the heirs of the murdered), *al-qasāmah* (an oath that was taken from the kinsmen of the murdered [in one such case the Holy Prophet (pbuh) paid blood money of one hundred camels of *ḥadaqah*¹] and *walā al-m-wālāh* (a contract in which one party agreed to bequeath his property to the other on the understanding that the benefactor would pay any blood money that may eventually be due by the former). Islām accepted these arrangements of mutual help and mitigating the impact of harms and losses to human being or the assets as is evident from *hadith* of *al-‘ash‘ariyyin* (حديث الأشعريين) according to which the Holy Prophet (pbuh) paid tribute to his ‘*ash‘ariy* companions who put forward a mutual help concept and practiced it in their life as explained by Imḡm Nawavi (شرح النووي على صحيح مسلم) 62/16).

¹ Sahih Muslim, Book 16, Kitab al-Qasamah.

Risk mitigation through any Sharī'ah conforming strategies is allowed on the basis of the following tenets of the Sharī'ah/ sayings of the Holy Prophet (pbuh):

- “Whosoever fulfils the intended need of his brother, Allah will fulfill his needs; and Allah always helps he who helps his brothers”. [Musnad Ahmad and Abu Daud]
- “ Tie your camel and then have *tawakkul* in Allah”
- “To leave your heirs wealthy is better than to leave them helpless asking people for their needs”
- “Love your brothers as you love yourself”
- “Believers support one-another”
- Hoarding of wealth is a disliked act.

The Holy Prophet (pbuh) also encouraged the providing of security for the widows, orphans and the poor as he highlighted in one of his sayings: *“The one who looks after and works for a widow and for a poor person (dependent), is like a warrior fighting for the cause of Allah, or like a person who fasts during the day and prays throughout the night”*.

As an alternative to the insurance business, *takāful* is to transform the nature of the arrangement from a commutative contract to the gratuitous concept. Mutual relationship among the participants in *takāful* has to be that of partners for a good common cause who pool resources for fulfilling the needs of one another and for mutual indemnification of losses to any of them as approved by Islām. There has to be full disclosure and transparency so that none of the stakeholders exploits the others. The *PricewaterhouseCoopers* (PWC), a multinational professional services network, paid tribute to this system in the following words:

“The world’s youngest and most dynamic insurance market in reality traces its origins back more than 1,400 years. Takāful, the name for Islāmic-compliant insurance, can be translated as ‘shared responsibility’ and refers to the co-operative risk-sharing beginnings of takāful – not unlike the birth of insurance within different communities in Europe and the US”.²

² PWC, Takāful: Growth opportunities in a dynamic market, available at: <http://www.pwc.com/gx/en/financial-services/islamic-finance-programme/takaful-growth-opportunities.jhtml>

However, as the system evolved, it practically took the form of commercial ventures with many Sharī‘ah related issues notwithstanding the use of Islāmic concepts like, *tabarru‘*, *ta‘wun*, *waqf*, *kafalah*, etc. The real concept of *tabarru‘* is missing in the arrangement; the amounts are taken in the name of *tabarru‘* without any proper disclosure to the clients, and the ultimate beneficiaries are the high-ups, marketing teams and the operators as in the case of insurance companies. Almost all *takāful* companies are owned by the shareholders and managed as a business on the basis of *wakalah* and/or *mu‘ārabah* rendering the system commercial in nature. Various models are operating: *mu‘ārabah* model in Malaysia; *wakalah* model in the Gulf; *waqf / wakalah* model in Pakistan and South Africa and a hybrid of *wakalah* and *mudārabah* model used by some companies in Malaysia. The system is akin to the commercial insurance companies also for the reason that the same marketing strategies, allocation to reserves, sharing of underwriting surplus (UWS) by the companies one way or the other, providing loans to the *takāful* funds as a practice and resultantly absorbing the underwriting losses (UWL). The basic ingredient of all these models is *tabarru‘* with meaning of donation, but there is no standard contract for taking the contributions and their distribution into various heads, parts going to protection or investment heads, payments to the distribution teams as agents in the form of commissions, incentives and bonuses. Many types of *wakalah* and non-*wakalah* fees and charges (acquisition fee, entrance fee, additional statement fee; membership administration charges, incentives and various bonuses to the distribution agents) are taken from ‘regular’ contributions, any increases to them, and top-up policies, etc. As in the case of insurance companies, roughly 15 years’ and 5 years’ fees are taken in the first and the second years of 20 years *takāful* policies, respectively, for example, and the policyholders reach the break-even only after 4 / 5 years. Further, the entity becomes effectively risk taker one way or the other, as in the case of conventional insurance.

Hence, some basic issues need to be addressed. IRTI and IFSB observed in the Mid-Term Review (MTR) made in May this year, “Until the core features of *takāful* are identified, it will remain difficult to promote *takāful* as a value-driven ethical product (IFG Portland May 25, 2014). In our view, the most serious issues are that of the structure of *takāful* entities and the “potential” commissions and kick-backs.

Changing the Basis and the Procedures of *Takāful*

The above discussion implies that the cooperation and mutual help based system, also cherished by Islām, is good, but its practical manifestations are problematic limiting its benefits to a few groups and hindering its acceptability among the faith based clientele at broader levels. Here we suggest mainly two types of steps to re-align the system to make it really Sharī‘ah compliant and beneficial for the societies at larger scale:

1. Changing the structure of *takāful* entities to make them really mutual and cooperative; and
2. Role to be played by Islāmic banks in evolving the system in true spirit of mutual help and mitigation of the impact of losses to human beings and their wealth.

To be really worthwhile, entities providing *takāful* services need to be restructured on “mutual” and “cooperative” basis to include organisations whose structure and values reflect the mutual/cooperative form, i.e. companies which are owned by, governed by and operated in the interests of their member policyholders, in addition to the promoters, regardless of historical circumstances of establishment. These may include limited companies owned by people-based organisations, fraternals, friendly societies, *takāfuls*, reciprocals, non-profits, community organisations and foundations, although their legal status may not always be classified as such in their national law (ICMIF; August 2013 Issue³). The participants/policy holders may be partners like promoters as in case of ‘Mutuals’ working in America, Japan and the West. In other words, managing a pool for mutual indemnification by group members should not be a business for the companies. Rather, the participants should also be owners, paying claims and getting underwriting surplus (UWS) or bearing the underwriting loss (UWL), in case the *takāful* pool is in surplus or runs into a deficit, respectively. The system based on *musharakah ta‘awuniyah* concept will neither be a commercial partnership, nor be a case of the insurer and the insured. As in case of *al-nahd*, the partners/contributors could validly expect to get help as would be agreed in the contribution agreement.

The *musharakah ta‘awuniyah* concept was proposed by some Sharī‘ah scholars at the conference on “*Cooperative Insurance: Dimensions, Perspectives, and the Position of the Islāmic Sharī‘ah*” held in Amman in April, 2010 in collaboration with the Islāmic Fiqh Academy of OIC, IRTI

³ ICMIF, *Takāful & Mutuality*, (August 2013 Issue);
<http://www.takaful.coop/images/stories/Takaful%20&%20Mutuality%20Digital.pdf>

and others. Further, the Islāmic Fiqh Academy recommended in its 20th Session held in September 2012 for cooperative arrangement, based on donations and cooperation, which has to be different from the commercial insurance. The elements underpinning the concept of *ta'awun* can be broken down into the following: i) Mutual responsibility; ii) Mutual cooperation; and iii) Mutual protection. All these principles are approved by the Sharī'ah; we quote a few such tenets as below:

- a) *"Help one another in furthering virtue and God-consciousness, and do not help one another in furthering evil and enmity" (Qur'ān 5:2).*
- b) *Holy Prophet (pbuh) said: "By God in Whose power I am under, one will not enter paradise unless he provides protection to his neighbor in difficulty." (Ahmad).*

Takāful as a system of cooperation and mutual help at times of grief or happiness must not aim at deriving advantage at the cost of others, and possibly the best such system could encompass cooperative participation by the members for its operation. Mutual relationship among the participants will be that of partners for a good common cause who pool resources for mutual indemnification of defined losses to any of them. 'Policy distribution' would not be a business for many, particularly the high-ups sitting in the Area / Head Offices, getting a major part of the contributions in the initial years. Keeping in view the features of various models in vogue, it can be said that the companies working as *Mutuals* could be considered as the highest in ranking. The members/partners will be transferring the ownership to the common pool as they will contribute, while at the time of getting any help they would be taking ownership, and both activities would be independent – one is not in direct exchange of the other. It is pertinent to note that Imām Bukhari, in his Sahih, has reported the custom of *nahd* as '*tarjuma tul-bab*' (preface of the chapter), under *kitab al-shirkah* and chapter captioned, "*partnership in the food, group contribution, exhibition, and the distribution method of what is measured and weighed randomly or by possession; since in the case of resources that are pooled for the common good, Muslims did not see anything wrong to eat all by sharing whatever they have, and likewise sharing the risk of gold, silver, and conjunction in the dates*".⁴

According to a recent research (ICMIF 2013), mutual and cooperative insurers have significantly outperformed the total insurance market since

⁴باب: الشراكة في الطعام والنهد والعروض وكيفية قسمة ما ياكل ويوزن مجازة أو قبضة قبضة لما لم يَرَ المسلمون في النهد بأساً أن يأكل هذا بعضاً وهذا بعضاً وكذلك مجازة الذهب والفضة والقران في التمر.

the onset of the global financial crisis of 2007-08. Converting the *takāful* entities into the *Mutuals*' structure should not be a big problem. The shift has already started. In four of the five largest insurance markets, mutual insurance accounted for over a third of the market. Speaking at an international cooperative summit in Québec in October 2012, McKinsey's Global Managing Director, Dominic Barton observed, "*The time has come for the [cooperative] model to be put forward and celebrated.*" He called for a shift in the business world from a focus on shareholder values to stakeholder values.⁵

However, there has to be a standard agreement incorporating the principles of gratuitous contributions and payments for investments with separate rules and clauses for each. It is argued by some scholars that the concept of *tabarru'* as being applied is *hibah bi shart al-'iwad* that is considered equivalent to a sale contract as per *Maliki* jurists. It has to be replaced by the concept of *al-iltizām bit-tabarru'*, as accepted by the majority of the scholars, which implies that "*the one who commits himself to doing a virtue is obliged to do so*". The eminent jurist Shaikh Siddiq al-Darir has argued in favour of this concept that although it comprised two commitments, i.e., donation and indemnification, yet the latter is probable. It depends on the occurrence of specified hazards or perils, while in *hibah bi shar= al-'iwaḥ*, the commitment to recompense is definite - for instance, if A gives \$ 200 to B, B should give something in return to A. It is not the case of contribution in the form of *al-iltizām bit-tabarru'* when some people commit to donate for any agreed common cause.

The *Sharī'ah* allows that if members of a group agree, their contributions, or any surplus thereof upon any unit of time could be used for benefit of those who may incur any defined loss; or in case of surplus after payment of all claims, for any others for covering their losses, or distributed to all of them, equally or pro-rata to the contributions. There would also be some reserves kept for claims payment in future. Participants may mutually agree that all surpluses could go to reserves for payments of possible claims in future, or may go to charity for covering losses to other risk pools.⁶ The same principle can be applied to similar issues confronting actuaries in allocation of contributions to protection, investment or charity pools. It is pertinent to observe that as

⁵ICMIF, *Takḥful & Mutuality*, 2013, op.cit.

⁶AAOIFI has already incorporated such provision in its Standard on *Takḥful*: Upon liquidation of the company all reserves pertaining to *Takḥful* Fund have to be spent on charity (Standard No. 26; Clause 5/6).

actual/ultimate risk cannot be determined in advance, the *tabarru'* rate has to reflect the probability of a claim that the participant brings to the pool. Hence, higher the perceived risk of a potential claim, the higher could be the *tabarru'* rate and the higher the sum covered, the larger would be the contribution amount. All these aspects need to be taken care of while preparing any standard agreement. There must be complete disclosure to the participants who may be agreeing to enter into the gratuitous contract.

Cooperative non-profit institutions can work properly in smaller scale – at local levels in various areas/markets or at the national levels. Global support would be needed from the infrastructure institutions working at multinational levels to prepare the standard agreements and the products, provide *re-takāful* facilities on the same basis, and to coordinate the institutions working at national levels. Firm resolve of the political leadership in various jurisdictions and their patronage is a key factor in establishing such cooperative entities for mutual help and indemnification and for their successful functioning. Hence, a major challenge for implementing the suggested cooperative *takāful* is to frame a special regulatory framework for their successful functioning so that unscrupulous elements may not exploit the members of such cooperative institutions.

Role to be played by Islāmic Banks

Takāful is a crucial part of the Islāmic finance system being evolved over last four decades as it is necessary to fulfil the increasing needs of Islāmic banks in respect of leasing / *ijrah* and home mortgages, personal lines for property and casualty related services for individuals. The cycle is not complete unless there is an efficient system of risk mitigation as alternative to insurance. In this perspective, currently Islāmic banks seem to be beneficiaries, or at the most, corporate clients of the *takāful* companies. In recent years, some of the Islāmic banks have also been offering Banca *Takāful* policies serving as agent to the *Takāful* Companies. They market and sell the products via their retail branch networks to prospective participants and distribution fees are charged and bonuses taken in the same manner as in case of conventional insurance. The procedure might be even more exploitative due to involvement of another layer of '*professionals*' from banks although they do not have to undertake that level of effort for policy distribution as in the case of individual distribution agents. In this status, therefore, the *takāful* system has not been able to deliver⁷ as it should have delivered as an institution

⁷Another area where *takāful* companies have reportedly failed to deliver is the current practice of treatment of depreciation of assets for *takāful* policy holders at the time of

for lessening the miseries in the society and for broad based community development. Opening *takāful* windows by the insurance companies, as SECP suggested in July 2012, would also not be adding any value in enhancing outreach of the *takāful* products at broader levels unless it is done with enhanced emphasis on maintaining “firewalls” to separate insurance from the *takāful* side⁸. Without these “firewalls” it could rather damage the credibility of the system with regard to Sharī‘ah compliance.

Distinctive ‘Meezan Kafalah’ Product

The *takāful* product introduced recently by the Meezan Bank Limited (MBL) is, however, different and carries good features both for protection as also investment plans. The funds deposited by the policy holders are allocated to a deposit pool on the basis of *muḥārabah*, which are invested by the bank, while in *wakālah*, the customer appoints MBL as agent for facilitation in the collection of *takāful* cover contribution. MBL, while paying to its officials for policy distribution from its own account does not charge, reportedly, any fee from the *takāful* policy holders. While there are a number of tailor-made options, monthly profit payments are reinvested in *kafālah* plan. There is an easy exit option any time having 100% cash value along with the profit, if earned. While the cash value has to be paid by MBL, *takāful* cover will be paid by the *takāful* Company⁹.

All IBIs operating in Pakistan need to follow MBL’s banca *takāful* process with some changes, if needed for further improvement. We will rather recommend to the regulators that as the banks have not to undertake as much efforts and expenses as required in the case of individual distribution agents, IBIs may not be allowed in Banca *Takāful* to charge any distribution fee from the policy holders and the benefits must go to the policy holders. A thorough study may be conducted by a joint team of the SBP and the SECP experts to explore pros and cons of MBL’s product and to suggest the process making banca *takāful* a really useful tool for mutual risk and reward sharing by way of *takāful*. As the scheme carries

settlement of claims for coverage of assets as it seems to put them at a relative disadvantage vis-à-vis conventional policy holders.

⁸Stand-alone type of *takāful* windows of insurance companies might be useful for the time being in the scenario wherein both the systems are in operation and per entity limits are sanctioned by top management of banks favouring insurance companies (with comparative disadvantage to *takāful* companies), which reportedly pay hefty kick-backs to the limits sanctioning authorities. This kick-back feature is another serious reason for slow growth of *takāful*.

⁹ <http://www.meezanbank.com/kafalah.aspx>

momentum, it could prove to be a conduit of mutual help and community development as the original concept of *takāful* requires.

IBIs to Establish *Takāful* Entities as Mutuals

The step as suggested above would certainly be a leap forward; but we need to cover another milestone for achieving the objective of mitigating the losses with mutual efforts and community development in true sense. Taking a further step, Islāmic banking institutions (IBIs) operating in the country, or elsewhere in the world, may establish *takāful* entities as ‘Mutuals’, as discussed above, on syndication arrangements. There could be separate ‘Family *Takāful*’ and ‘General *Takāful*’ companies established on the principle of *mushṭarakah at-taʿwuniyah*. Relatively smaller capital requirement as per SECP Circular No. 03 of 2007¹⁰ [PKR300 million and 500 million for **General** and **Family** *takāful* and re-*takāful* companies, respectively] makes it easy for them to establish syndicated companies for specific areas keeping in view risk profiles and the prospects of future investment plans of their clientele. Similarly, the existing *takāful* companies may jointly establish, as a pilot project, a “*Re-Mutual*” on syndication basis to offer mainly the re-*takāful* with permission to offer *takāful* as well. In the mutual’s structure, the participating banks / *takāful* companies would be the promoters and policy holders would be pro-rata partners/ members having ‘say’ in management of the protection and investment pools as per their votes that could be administered periodically through internet/on-line. Members will be providing contributions to the common pool(s) managed by the promoters / selected members, as jointly decided by them.

For the above transformation, the regulators (SECP, or others in case of various jurisdictions) would need to frame rules for functioning of *takāful* companies as mutuals. The proper implementation of the proposed system will require sufficient support from the State institutions like Registrar of Companies, Securities Commissions, Ombudsman’s offices and even the monetary and finance authorities. Preferably, there should be separate entities for family and general *takāful* because of their different objectives and risk profiles – focus on future planning / investment plan in case of former, and risk mitigation in case of latter. As required in the Malaysia’s IFSA 2013, separation of licences for life and general *takāful* may make it easier to implement cooperatives model of mutual indemnification for community welfare.

¹⁰ http://www.secp.gov.pk/circulars/pdf/Cir_2007/Apr_10_PaidupCapitalCirc.pdf (accessed on May 16, 2014)

The above step could become a motivating factor for the *takāful* companies in general to change their policy distribution patterns to make them client-friendly¹¹ and to transform themselves to the mutuals' structure with passage of time.

Takāful in cooperative structure could become an institution for social and financial inclusion of those who either abstain from the conventional insurance system due to Sharī'ah prohibitions, or are not in a position to approach these institutions due to some deficiencies. It may provide a fair opportunity to all segments in a society not only to get the much required risk cover in societies where social welfare programs are lacking, but also might change the present '*self-centeredness*' scenario to mutuality and cooperation as required by the Sharī'ah. The concept of social inclusion is a major issue in such societies where the poor do not get opportunities because of cultural and economic divide. The recommended system has capacity to become a unique community development institution for broad-based development. The community members will be helping each other in all time of sorrow and happiness. It will also provide opportunity to people to plan for future needs and invest their savings in the light of the Sharī'ah principles. As the members themselves would be approaching the respective *takāful* entities, there might not be pilferage / exploitation in the name of distribution fees and related incentives / bonuses payable to the distribution agents. In addition to a well thought-out regulatory framework and commitment by the concerning State institutions, joint efforts by other stakeholders like the Sharī'ah scholars, academicians, print and electronic media, the practitioners and the members of the society as a whole need to play dynamic role for success of the system functioning in line with the Islāmic principles of brotherhood, harmony and cooperative risk sharing.

¹¹Meaning that the sharing arrangement should not be adversely skewed against the general participants.